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Review of the UK funds regime—an analysis

Tax analysis: Mark Stapleton, Richard Frase and Daniel Hawthorne, partners at Dechert, discuss the government's recent review of the UK funds regime.

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What are the government's objectives behind this call for input on the UK funds regime?

The UK possesses the largest asset management industry in Europe and it generates 10% of the UK's total tax revenues. It is therefore an important sector to the UK and the government recognises the need to carry out a review to improve and enhance the competitiveness of the UK's fund range offering, in particular in comparison to its EU competitors post Brexit.

The government also sees this review as an opportunity that could lead to the promotion of new jobs outside of London in the key ancillary fund support sectors such as fund custody and administration by increasing the number and market share of the UK funds industry.

More specifically, the aim of the review is to promote more efficient investments, better suited to investors needs and to unleash additional investment into productive, sustainable and green technologies. There is a desire to improve routes through which capital can be committed to long-term assets. This is perceived to be important for pension funds and other long-term investors including retail investors in order to provide a source for diversification and potentially enhanced investment returns. This could also provide a source of capital to upgrade infrastructure, transition to a carbon neutral economy and support innovation to private enterprise.

The call for input is extremely wide-ranging, covering direct and indirect taxation of funds as well as areas of fund regulation, and it includes several suggestions for more fundamental reform. What are the key issues relating to funds taxation that are being considered and why?

One of the overriding key tax considerations government has recognised is the need to achieve tax neutrality for investors. This means that fund investors should be in a similar tax position to the position they would have been in had they invested in the fund assets directly. As the government states, in many scenarios, UK funds do achieve an appropriate degree of tax neutrality but certain specific areas of concern are recognised. One of these is with respect to mixed or balanced funds that hold both debt and equity investments. Here, the 'bond fund' rules may not apply, and as a consequence additional tax liabilities that are not matched by tax deductible payments arise.

In addition, the whole question of the VAT treatment of investment management fees is recognised as being of fundamental concern. Investment managers currently do not need to charge VAT to non-UK funds and in most cases are also able to achieve full VAT recovery on related input tax. This is not the case for investment management fees charged to UK funds at present (albeit that no VAT need be charged in the case of authorised funds) and perhaps the only way to achieve parity with the current position for non-UK funds would be to introduce zero rating for investment management fees charged to all UK funds.

The current UK tax regime, while in many cases achieving tax neutrality, is fraught with complexity at times and can also involve significant administrative burden. A simpler and potentially more competitive option would be to introduce a tax exempt fund regime, and this is therefore also under consideration. In this regard, the government has expressed concern about the potential inability of such a tax exempt fund to access treaty benefits, although it should be noted that tax exempt funds in Ireland, for example, appear to be able to achieve double tax treaty benefits in many scenarios.

The government is also keen to ensure that UK funds can benefit from owning the newly proposed tax efficient UK asset holding company that has been the subject of a separate related work stream, and this will be another potential way funds can achieve double taxation treaty access.
The government is also considering changes to the REIT rules to remove unnecessary barriers and complexity as well as looking for input in relation to the use of UK limited partnerships.

The fund structures available in the UK for tax planning purposes are also limited in scope. The only corporate open-ended fund structure is the ICVC, which is an authorised, heavily regulated product. The only closed-ended corporate structures available are the investment trust and the REIT, both of which have, in practice, been listed. Developing a more flexible range of UK fund structures should be an important theme of the review.

What do you consider the most interesting proposals to be?

Different aspects of the proposals will appeal to different people. For Dechert's private funds practice, the possibility of introducing a new tax exempt private fund aimed primarily at professional investors is of great interest. We spend much of our time acting for UK investment managers in establishing private funds in places like Cayman, Luxembourg and Ireland and this results in our clients having to establish expensive fund /fund management infrastructure outside the UK in these jurisdictions and having to travel for board meetings that are typically held in those jurisdictions. If you were to consider the investment management industry afresh as an outsider you might be forgiven for wondering how the UK has allowed this to happen.

Of course, some investors may simply not want to invest in the UK but our expectation is that many sophisticated institutional clients would be prepared to do so if the tax and regulatory framework and the associated cost of doing so made this viable. To achieve this it will be important to create a more straightforward set of tax rules, such as a tax exempt fund alongside a more relaxed regulatory framework that would address issues such as enhanced leverage, ability to invest in a wider range of asset classes, enabling more flexible liquidity profiles and maturity terms for funds. The new fund range might include an unauthorised fund (so that regulatory flexibility is automatically available), or a fund that is regulated in a way that is flexible and allows speed to market. Allowing such a fund to be established as an open or closed-ended corporate would also be a welcome development, as would the removal of the listing requirement for investment trusts and REITS.

It will be important for the UK fund regime to be competitive and so the bottom line is to look to the competition. In the context of hedge funds the competition is mainly with the Cayman tax exempt fund whereas Irish and Luxembourg funds tend to lead the competition in the context of alternative credit or private equity fund strategies.

The other proposal of key interest is the long-term asset fund, envisaged as a response to the liquidity problems experienced in the collapse of the Woodford UCITS fund in 2019. The new product would be targeted at longer term illiquid investments such as infrastructure and venture capital while retaining authorised fund status. This would be attractive to pension fund and other long-term investors including retail investors. Here, the government may want to look to the U.S. BDC (Business Development Company) which currently facilitates more than US$100bn of capital investment into the US economy as a benchmark to base the introduction of a similar new UK fund.

How is the call for input being received, and do you think it will lead to significant change?

At Dechert, we are optimistic about positive change. If the attitude of HMRC and HMT in relation to the UK asset holding consultations is anything to go by, there is reason to be optimistic. That said, clients are unlikely to uproot existing overseas infrastructure overnight, so the opportunity is really in relation to the introduction in the future of new UK funds rather than onshoring existing non-UK funds.

There are undoubtedly significant tax and regulatory hurdles to overcome (not least the VAT treatment of investment management fees). Nevertheless, if these hurdles can be overcome, there will be UK-located investment fund managers who will welcome the opportunity to also establish funds in the UK, particularly where the investor base is primarily UK and non-EU based.

It will also be key to the success of any new UK fund range for the government to give the right signals about the stability of a tax-favoured regime going forward to counter any concerns with respect to a future reversal or adverse change in the regime under a different government.

Interviewed by Tom Inchley

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